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THE NATIONAL CITY BANK OF NEW YORK
1812 - 1952

Monthly Letter on Economic Conditions Government Finance

New York, January, 1952

General Business Conditions

THE United States in 1951 has accomplished the stupendous feat of supplying goods and services valued at $34 billion for defense; providing $23 billion in new plant and equipment for industrial growth and improvement; carrying out a new construction program, exclusive of industrial plant, of $22 to $23 billion; and at the same time meeting everyday needs for civilian goods so abundantly that producers of these goods in most cases have not been able to sell as much as they could turn out. Many are on short-time operations, by reason of satiated markets as well as shortages of materials.

The dollar in which defense, plant and equipment and construction expenditures are expressed is a depreciated dollar. Thus the totals – like other gigantic figures used to describe current economic activity – are deceptive to the extent that they reflect inflated prices. Nevertheless, records have been set in physical output also. According to the Federal Reserve Board's index, industrial production has exceeded 1950 by 10 per cent, 1949 by 25 per cent, 1948 by 15 per cent, and has surpassed every other year except the two peak war years. Total output of goods and services, in real terms, has been larger than even in the peak year 1944. The investment in plant and equipment, allowing for higher prices, appears to have approximately equalled 1948, the previous record year. The volume of construction has been about the same as in 1950, and with that exception the highest in history.

By supplying all these needs the productive organization has done more than most people, at the beginning of the year, believed possible. It has maintained, if not increased, the real living standards of the country, as measured by the useful goods and services consumed. It has added to the national wealth in the form of enlarged and more efficient productive facilities, more housing and state and local improvements, and greater stocks of durable goods. It has done these things while carrying forward the defense program at a rate which the Defense Production Administrator finds up to reasonable expectations in most respects, although it is much behind original schedules and is impeded by machine tool shortages and other bottlenecks.

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Fears of Shortages Allayed

Most impressive of all, this huge production has demonstrated again – as was demonstrated during the war – the power of this country to meet extraordinary demands. It has allayed fears of shortages, influenced buying policy on the side of moderation, and thus helped to quiet the alarm which for some time after Korea excited speculation and anticipatory buying. It has helped make people less eager to spend, and more willing to save.

During 1951 the pace of the price advance was slowed. Basic commodity prices on the average are lower than they were at the end of 1950; and the official wholesale price index is almost exactly the same, after rising early in the year and falling later. The cost of living (consumers' price index), however, has risen

5½ per cent during the year, which reflects the passing on of earlier rises in basic commodities, advances in wages and cost of services, higher rents, increases in excise taxes, and other lesser factors. The continued rise in living costs is evidence that the inflationary forces have not been finally routed, but on the contrary have continued to work their way through the economy.

Influences on Business in 1952

In the record of 1951 can be seen a variety of influences which will affect business in 1952, and also the problems that the year may bring forth. Barring unpredictable international developments or drastic changes in defense planning, the dominant influence on industrial activity will be the defense orders now on the books and those currently being placed at a rate averaging around $1 billion each week. In many cases the work required to fill orders on hand is still in the preparatory stage – plant construction, tooling, and accumulation of materials and parts. Deliveries will stretch far ahead. No decline in placement of orders is expected in the first half of 1952.

There is uncertainty as to how high defense expenditures eventually will go, and how rapidly they will move up to the peak. Indications now are that the rise will be more gradual than originally planned, and spreading out the program may lower the peak also. More will be known about these matters when the federal budget is published. But expenditures in 1952 are certain to exceed greatly the $34 billion of 1951, and to reach an annual rate far above the present $40 billion. Preliminary budget estimates imply an increase of 50 per cent or more in both figures (which include funds for foreign military aid and the Atomic Energy Commission).

These expenditures, representing in increasing degree demand for materials and labor, will be the principal influence for expansion in 1952. Along with them goes the demand from the defense-supporting industries, such as the railroads and utilities, steel, aluminum and others. It is early to estimate what private capital expenditures will be in 1952, but reports thus far indicate another record or near-record year. According to the quarterly survey of the Department of Commerce and the Securities and Exchange Commission, plant and equipment expenditures in the first quarter will reach $5.7 billion, which is 18 per cent more than the first quarter of 1951. Capital expenditures by nondefense industries topped off in 1951 and are now declining, but expenditures by defense and defense-supporting industries are still accelerating.

Construction is expected to drop a little, according to current forecasts. Inventory accumulation is almost certain to be much less than the $11 billion of 1951; in total, inventories may even decline. Demand on that account therefore will drop sharply, as compared with 1951. Nevertheless, an industrial organization which has to produce so much more for defense in 1952, and as much or nearly as much industrial plant and equipment, is unlikely to experience any decline in overall activity. On the contrary, it will be under pressure in many areas.

Consumer Goods Still Depressed

The consumer goods industries are in a unique position. They are relatively depressed while activity otherwise is booming. Their troubles go back to the beginning of the Korean war and the almost-successful Chinese offensive last winter, which caused people to expect the impact of the defense program to be more rapid and severe than it actually has been. This miscalculation, fostered by alarmist predictions, led to over-buying, over-production, and overstocking, from which the correction is still under way.

Since last spring buying has slackened at retail and even more at wholesale and the factory level; and although the situation is no longer deteriorating, there are few convincing signs that it is improving much. Christmas business, to judge by the fact that department store sales in four weeks ending December 22nd were even with a year ago, has been good, inasmuch as last year's figures were exceptional. But it has not been as good as merchants expected and prepared for, for many believed that after the long lull during the summer and autumn a 4 or 5 per cent increase could be realized. In the merchandise trades generally the emphasis is still on cutting down inventories. Stocks of durable goods relatively are higher than stocks of soft goods.

The period of inventory liquidation has been running for a good many months. Its effect has been to reduce production and employment in the industries concerned, to drive prices below ceilings, and to narrow profit margins. Production of consumers' durable goods is restricted additionally by the severe limitations on the use of metals, which the defense authorities now say will be tighter in the second quarter than in the first. The difficulties of producers and distributors, however, have been sustained without grave losses or a notable increase in failures,

and the influences that will make for improvement in due course are in sight, namely, sustained high purchasing power and reduction in stocks all along the line.

A Precarious State of Balance

This sluggishness in consumers' goods demand, with the accompanying increase in saving, provides the principal explanation for the good balance between inflationary and deflationary forces which has existed during the past few months, and for the failure of the extreme inflationary predictions of a year ago to come true. While other kinds of demand were expanding and personal incomes rising, personal buying has subsided. Market conditions have forced price-cutting rather than expected price advances. Compulsory curtailment of production, where enforced, has not caused the shortages that were predicted. The money that has been saved instead of spent has helped swell the supply of investment funds available to finance the demand for capital goods and construction. The pressure on the labor supply from defense and defense-supporting plants has been eased by the release of workers from consumers' durable goods plants.

Shifts of production and employment from consumers' to defense output are necessary to carry out the defense program, and have to be accepted as part of its cost. The unique experience of 1951 is that demand has shifted concurrently, in most timely fashion. The inflationary pressures thus have been reduced and the problems of the defense and control authorities eased.

The Inflation Problem

To many people the present state of balance is somewhat surprising, and probably not many expect it to last through 1952. The pressing question is whether the price rise will be resumed, living costs advance further, and the dollar show continued depreciation. The conditions under which inflation thrives will be present. While areas of unemployment will exist, at least temporarily, people willing and able to work in the main will have jobs at high wages, and the part of their product which goes for defense will not return to the markets to absorb their purchasing power. Most estimates of consumer expenditures for 1952 forecast an increase, at least after January and February, when last year's figures were abnormally high. The declaration of war by the C.I.O. on the wage stabilization program, and the demands of the steel unions, threaten higher wage rates, which if granted will raise wage and salary payments further. The other side of the shield is that industrial costs will also advance. Upward pressures on prices will be created.

The lessons of 1951, already touched on to some extent, point to the way to contain these pressures. It is not correct to say that increasing production of itself will suppress inflation, since that cannot be true if purchasing power rises faster than production and if the money is spent. But increased output has a profound effect in dampening inflationary forces, because demands for specific things are not infinitely elastic and any given market can be saturated. Of course purchasing power can move from one area to another, as from essentials into expensive luxuries and services, but the experience of 1951 shows it does not always do so. At some point people choose to save rather than spend. Business men, for their part, turn more conservative in their own buying. This is what happened during the past year. Thus the first lesson to be drawn is the need to work and produce.

No one knows now how people will behave in 1952. They have had a demonstration of the needlessness of alarm over fancied shortages of soft goods. Obviously, they are better stocked with hard goods and better housed than most people expected a year ago. But two dangers exist. One is that even if 1952 begins with individual soberness and restraint, a rise in wage rates, lifting money incomes, may increase demand excessively, and perhaps create another cycle of shortage fears and scare buying.

The second danger is that public extravagance, waste and confusion may generate greater alarm and cause a fresh rush into goods. Unless more progress in federal economy has been made than seems likely, or the defense program is to be reduced in scope and timing more than the country suspects, the forthcoming budget for the fiscal year 1953 will show a huge deficit, most of which will fall in the last six months of 1952. The first essential of anti-inflationary policy is to hold the deficit to the minimum by further curtailment of expenditures, both by reducing non-defense categories and cutting out waste in defense. The second essential is to finance the Treasury's needs by drawing on savings and genuine investment funds, and avoiding an inflationary expansion of credit.

In last analysis, what people think of the outlook will govern their behavior. A demonstration of resolute intention to halt depreciation of the dollar, through government economy and vigorous fiscal and credit policies, and a real

stabilization of wages within the present formula of the Wage Stabilization Board, would not only reduce actual inflationary pressures. It would also do more to encourage saving and restraint by people and business everywhere than anything else that is within the power of government to do.

Money Rates and Credit Policy

The hardening of money rates, which has been under way since the business recession of 1949, moved another step in December as banks raised the rate on prime commercial loans from 2¾ per cent to 3 per cent. In the historical perspective, this is one-half the 6 per cent rate that prevailed on such loans in the late 1920's, but double the 1½ per cent maintained during the full bloom of the easy money policy, 1935 to 1947. Open market money rates for Treasury bills, bankers' acceptances, and commercial paper also firmed up during December, by an eighth to one-quarter per cent, as the following table shows:

Short-Term Money Rates

	Dec. 31 1949	Dec. 30 1950	Nov. 30 1951	Dec. 28 1951
91-day Treasury bills	1.08%	1.38%	1.61%	1.88%
90-day prime bankers' acceptances	1⅛	1⅜	1⅝	1¾
4-6 months prime commercial paper	1¼	1¾	2¼	2⅜
Call loan rate	1½	2	2½	2½
Prime commercial loan rate	2	2¼	2¾	3
Federal Reserve discount rate	1½	1¾	1¾	1¾

One immediate factor in the advance of the prime commercial loan rate was a strengthened demand for funds combined with a manifest unwillingness of the Federal Reserve to put out more money except through the discount window. Early in December member bank borrowings ran up to $959 million, setting an eighteen-year record. The Federal Reserve Banks refused to put out any funds by buying government securities until the week ended December 26, when year-end pressures for money were strongest, and bank borrowings were again running up toward $1 billion.

A sundry list of other considerations also entered into the upward adjustment of loan rates: the "inflation" of bank operating costs, the unprecedented burden of taxes, desires to strengthen capital positions, competitive increases to more normal levels in rates paid on time deposits, and a higher evaluation of risk in the extension of credit under existing circumstances. The change is also symbolic of an increased caution in adding to loan volume which is at the highest percentage of deposits since 1935.

"Hands-off" Policy on Treasury Bills

The withdrawal of the Federal Reserve bids for government securities, during the vast churnover of funds characteristic of every December, was the most significant step taken by the authorities since the wartime par supports were taken out from under the bond market last March. It was all the more momentous since, during most of the month, shortage of loan funds was driving prices of government securities, long and short, to new low levels.

The absence of Federal Reserve support at the long end of the market was not so surprising, for the object of the bond unpegging was to get the Federal Reserve out from under the commitment to guarantee a set price to any holder wanting to sell. But, heretofore, whenever pressure has developed in the money market, which embraces the market for Treasury bills, the Federal Reserve has been fairly prompt to relieve the pressure with buying orders at some set point in terms of Treasury bill yields. This figure has changed from time to time but it was 1.39 per cent early in 1951, and 1.66 per cent from May through September. In the first three weeks of December, although pressure on the money market was at times relatively severe, the Federal Reserve maintained a "hands-off" attitude toward the Treasury bill market. For the first time since 1933 the banks, if they wanted more reserves from the Federal Reserve, had no alternative but borrowing.

The immediate background of this development is worth tracing. In the three months up to November 28 the Federal Reserve had first added $1 billion to their holdings of government securities, putting out more money to insure successful results on the Treasury's October-November financing, and then had cut back their holdings $800 million, mopping up surplus funds that were encouraging credit expansion. Substantially all of these operations — first purchases and then sales and runoffs — were conducted in Treasury bills and certificates (including certificate "rights") and within the price and yield ranges that had prevailed since June. From November 28 to December 19 the Reserve Banks held their portfolio of government securities at the November 28 level of $23.2 billion.

There had been no forewarning of this change of policy and the powers of adaptability of the market machinery were put to a test. The low discount rate of 1¾ per cent, the availability of plenty of acceptable collateral in the banks, and experience with previous controlled upswings in Treasury bill yields eliminated any sense of panic and the Treasury did not have any shortage of bids for the new weekly issues of Treasury bills. But the banks and government security

dealers had heavy work to do, finding buyers for bills put on the market, especially by corporations raising funds to meet December 15 income tax instalments. Some Treasury bills were offered on yield bases above 1.90 per cent before a buyer could be found, but the gratifying result was that buyers were found and without too much delay. The experience was a demonstration of the elasticity of demand for government securities. At the right price and yield, new buyers come forward. The holder of Treasury bills also came to learn that they are not the same thing as cash in the bank, that they cannot always be sold immediately, and that sale prior to maturity can produce a loss.

In the week ended December 26, the Reserve Banks bought $264 million government securities but even so member bank borrowings were up to $797 million at the close of the week.

Strength of Credit Demands

The force of credit demand remains strong. It takes more money than ever before in our history for employers to make up their payrolls, and wages continue to press higher under the prevailing conditions of "overemployment". Defense industries especially are adding to their borrowings, partly to meet working capital needs and partly to finance high-priced capital expenditure programs. In the last nine months manufacturers and distributors of consumers' goods, with encouragement from their bankers, have been working off inventories and borrowings, but seasonal trade expansion, and the movement to market of the crops, as in every autumn, have increased credit requirements.

In light of these facts, it is in many ways remarkable that bank loan expansion, since the unpegging in March, has run not much more than half the rise in the corresponding period of 1950. The bond unpegging of March and the Voluntary Credit Restraint Program, launched very soon thereafter, had key roles in establishing this record.

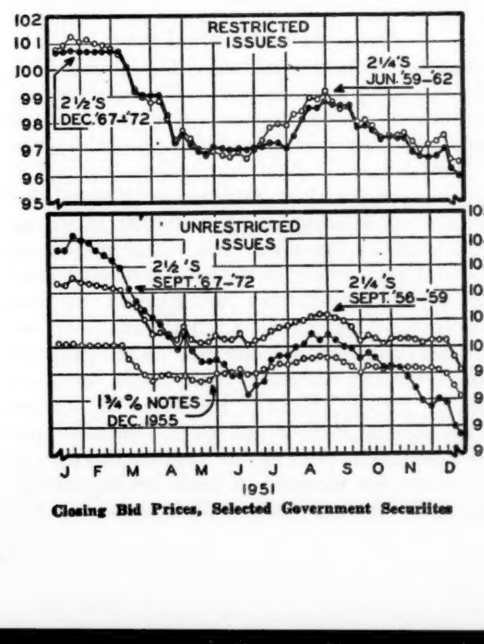
The policy of forcing banks to borrow if they want more funds, followed in December, is a signal that more caution should be applied in adding to loan volume. The means chosen almost insures the result.

Bond Prices Recede

The weight of credit demands has fallen not only on the market for short-term money, supplied primarily by commercial banks, but also on the long-term market, supplied primarily by life insurance companies, savings banks, savings and loan associations, pension funds, and individual lenders. Demands for long-term capital – from corporations, the mortgage market, State and local governments, and public housing authorities – have depressed bond prices in the past few weeks to new lows for the year.

The accompanying chart shows the price movements of five representative issues of intermediate and longer-term government securities during 1951. The initial declines in these issues which followed the pulling of the price pegs early in March, had pretty well run their course by the middle of May. The withdrawal of official buying support had a beneficial "shock" effect on lenders generally, forced sharp cutbacks in mortgage buying programs, and made government securities a competitively more attractive channel for new investment. From May through August government bond prices recovered to a point where buying interest waned while selling increased. The easing of mortgage credit terms on September 1, as required by the Defense Housing Act of 1951, a heavier volume of corporate and municipal borowing, and seasonal increase in demands for short-term money, played essential parts in the downdrift of government bond prices that set in after Labor Day.

As the chart indicates, the Victory Loan 2½s of December, 1967-72 and the 2¼s of June, 1959-62 – both restricted as to bank ownership – have moved in a fairly parallel fashion. The Victory Loan, which traded down to 96¼ in the middle of May and recovered to 98¾ at the end of August, went as low as 95⅞ during December. The 2¼s of June, 1959-62, which have the prospect of wider marketability next June when restrictions on purchase by commercial banks



Closing Bid Prices, Selected Government Securities

lapse, declined to 96⅛ during the spring, rose to 99⅛ in August, and traded as low as 95⅞ in December.

The longest term unrestricted government bond, the 2½s of September, 1967-72, struck its original low point of 98$\frac{1}{16}$ at the end of June, recovered to 100½ in August, and touched 96⅜ in December. The other two issues in the chart, in the intermediate maturity range, have fluctuated less widely in price. The 2¼s of September, 1956-59, which had an April low of 99$\frac{15}{16}$, last month traded down to 98¾, while the 1¾ per cent notes due December 15, 1955 went to 97⅞, a half point below their May bottom.

The following table compares current yields on various types of fixed interest obligations with those prevailing a year ago; on May 31, as the market restabilized after the unpegging; on August 31, after the summer's price recovery; and on December 28, reflecting the fresh decline in prices and advance in yield.

Bond Yields

	Dec. 30 1950	May 31 1951	Aug. 31 1951	Dec. 28 1951
Restricted U. S. Governments				
2¼s, June 1959-62	2.15%	2.57%	2.33%	2.62%
2½s, Dec. 1967-72	2.44	2.67	2.57	2.75
Unrestricted U. S. Governments				
2¼s, Sept. 1956-59	1.80	2.19	1.99	2.37
2½s, Sept. 1967-72	2.24	2.53	2.45	2.70
Corporate and Municipal				
Aaa corporate bonds*	2.66	2.89	2.85	3.04
Baa corporate bonds*	3.19	3.42	3.49	3.63
High grade municipal bonds†	1.72	2.12	2.02	2.13

*Moody's Investors Service. †Standard & Poor's Corporation.

These latest declines in bond prices, among other things, should renew the tightening effect of the original unpegging on the flow of funds into mortgage investments and relieve a little the pressure for scarce materials coming from capital projects in general.

Not a Deflationary Policy

In other countries—including the United Kingdom, Canada, and Australia — the monetary authorities, to put a stop on rising prices, lately have taken recourse to policies people describe as "deflationary". This description does not fit a policy of avoiding increase in Federal Reserve Bank holdings of government securities. Adherence to the same policy during January would see an easing of the money market, from the regular post-holiday reduction of currency circulation. Moreover, a continuance of the gold inflow which has occurred in the past five months would increase loan funds in some degree. Finally, there is the discount window at the Federal Reserve, which in December saw more customers than at any time in 18 years, as a recourse for increase in bank lending power. Any slack which develops will be taken up first by bank repayments to the Federal Reserve Banks. Some observers now anticipate a rise in discount rate as a means of making access to borrowings from the Federal Reserve less inviting to banks. The 1¾ per cent rate prevailing since August 1950 is out of line with present market rates.

Federal Reserve policy in December demonstated that the authorities have made prices of government securities a consideration definitely secondary to the amount of money they put out. It would now appear that they have assumed a firm control over their portfolio. So long as this is maintained, and discount rate is adjusted to suit the circumstances, the danger of accelerating inflation is reduced. For the next moves to strengthen the dollar the citizen will have to look primarily to curtailments of unessential government spending, the redress of the threatened fiscal 1953 deficit, and the redesign of government securities offered for general public subscription with a view to encouraging savings.

Towards Freer Foreign Exchanges

Canada's decision last month to end foreign exchange restrictions, and action at the same time by the British Government to reopen the London foreign exchange market to private trading, are both steps of leading significance. Of the two moves that by Canada takes precedence, in that it goes the whole way in reestablishing the Canadian dollar as a completely free currency and makes Canada the first country to abolish exchange control among those which imposed it as a war measure and continued it during the postwar period. The British action, though much more limited in scope, is also a step towards the freer foreign exchanges needed for expansion of international trade and investment.

Action by Canada

The action by Canada last month comes as the culmination of a progressive relaxation of exchange restrictions made effective over the past year or so.

On September 30, 1950, the Canadian dollar, which had been held by the Canadian authorities at 90 U.S. cents, was unpegged and allowed to rise. The following month travel restrictions were practically abolished, and early in 1951 the last of the import restrictions imposed for foreign exchange reasons were done away with. During the course of last year administrative procedures with respect to capital movements and other matters were relaxed. There remained (1) certain controls over exports limiting the

amount of Canadian shipments for which payment could be taken in currencies other than U.S. and Canadian dollars, and (2) controls over foreign capital repatriations and the flow of Canadian capital abroad for investment or other purposes.

Now all these restrictions are done away with. Canadians are free to do business anywhere, and both Canadians and non-Canadians are at liberty to shift capital to and from Canada at will.

Background of Canada's Decision

Basis for this sweeping de-control of the Canadian dollar lies in two things —

First is a hopeful attitude on the part of the Canadian Government regarding world peace. According to a statement by Finance Minister Abbott, as reported in the press, "We would not decide to make a move of this kind if it was felt that any outbreak of hostilities was imminent. Our planning is based on the fact that the measures we have taken and are taking will prevent war."

Second, and more important, is the marked improvement in the exchange position, and a feeling of assurance that this improvement can be held. Despite the relaxation of exchange controls and the strains imposed by rearmament the Canadian dollar has been remarkably stable. Following its unpegging it rose to 95 U.S. cents. It fluctuated narrowly around this level, until the latest move lifted it to 98¾ U.S. cents. The improvement in the exchange position as reflected in the rise of gold and U.S dollar holdings can be seen from the table below:

Postwar Movement of Canadian Official Gold and U.S. Dollar Reserves

(In Millions of U.S. dollars)

End of 1945	$ 1,508
The postwar low (November 1947)	480
The September 1949 devaluation	985
Outbreak of the Korean war (June 1950)	1,256
The postwar high (November 1950)	1,841
Latest available (September 1951)	1,611

The sharp rise in Canada's official gold and dollar reserves in 1950 reflected (1) the near-balancing of Canadian trade with the United States, which greatly stepped up its purchases from the Dominion, first because of business recovery here and later because of rearmament needs, and (2) a tremendous inflow of capital from the United States. Prior to the unpegging of the Canadian dollar in the autumn of 1950 a large part of this inflow represented American purchases of Canadian exchange in anticipation of a rise in the rate. But the inflow also included American and European funds attracted by investment possibilities in the development of Canada's great natural resources. Increased borrowing by Canadian provinces, municipalities, and corporations in the New York market also contributed to the total.

The year 1951 opened up with the United States imports from Canada levelling off but with Canadian imports from this country expanding by leaps and bounds. The bulk of this merchandise represented capital equipment and raw and semi-finished materials. Nothwithstanding a lower rate of importing during the second half of the year, the Dominion deficit on current account with the United States for the full year may have run as high as one billion dollars. Thanks, however, to a moderate surplus in current transactions with other countries, together with the continued inflow of capital, Canada's gold and dollar reserves experienced no serious drain. As will be seen from the table above, they were at the end of last September $1,611 million, or only $230 million below the November 1950 peak.

Is Canada Borrowing Too Much Abroad?

The huge inflow of capital, involving higher interest and dividend payments to non-residents in the future, has raised some question in Canada as to whether the country may not be borrowing too much abroad.

On this point it will be of interest to cite the remarks by Mr. Louis Rasminsky, Executive Assistant to the Governors of the Bank of Canada and Alternate Chairman of the Foreign Exchange Control Board, in an address in Toronto last October. Mr. Rasminsky reminded his hearers that a current account deficit such as Canada has experienced in the past two years is no new development in that country's economic history, nor is it uncommon in the development of other new countries. Indeed, he stated, the two most dynamic periods in Canada's history — 1900 to 1913 and the 1920s — were, like the present dynamic period, characterized by large net imports of capital, that is, by large current account deficits. Continuing, he said:

> Even after the large recent borrowings abroad through the sale of bonds, total interest payments abroad are very much lower than they were twenty years ago. True, much foreign capital has been invested in Canada during this period in equity form — through purchases of securities and investments in branch plants. But even allowing for this, the $400 - $450 million we shall pay in interest and dividends to non-residents this year represents only 2½ per cent of our national income, compared to 8 per cent of our national income required to make payments of $350 million in 1930. In 1930 it took nearly 20 per cent of the proceeds of our exports to meet our interest and dividend payments to non-residents. Today, even though these payments are larger, it takes hardly more than 2 per cent of our export proceeds to meet them.

Finally, one must have regard to the ways in which we are disposing of the resources available to us, including that portion which is made available through the current account deficit and paid for by an increase in our foreign indebtedness. Some part of our imports is unproductive, and debt incurred to finance them would have to be regarded as dead-weight debt. I suppose that this would be true, in an economic sense, of our imports of defense goods, which the Minister of National Defense recently estimated were running at the rate of $300 million a year.

On the other hand our domestic capital structure is being enlarged and intensified . . . The bulk (of new investment) is going into basic resource developments which will enlarge our capacity to export or reduce our import requirements. From a foreign exchange point of view therefore, it is reasonable to suppose that the borrowing is producing its own rent, with something to spare besides. And, fortunately, much of the resource development which is now taking place is directed towards producing commodities which are urgently needed for our defense effort and that of the countries with which we are allied.

The Key to Exchange Stability

That the Canadian authorities are well aware of continued uncertainties in the international situation is evident from the statement by Mr. Abbott to the Canadian Parliament that —

it has fortunately not been necessary for me to make any forecasts regarding the tranquility or roughness of the waters which lie ahead; my task has been the more limited one of trying to decide whether there is sufficient likelihood that we shall wish to make use of foreign exchange restrictions to deal with whatever problems do in fact arise in the future to justify the continued retention of the powers contained in the Foreign Exchange Control Act and the administrative apparatus necessary to carry out its provisions.

In mapping his course, Mr. Abbott has recognized the principle that stability of the currency is a matter largely of the soundness of the economic policies pursued at home, with particular emphasis upon the avoidance of inflation. Determination to abide by this principle is shown specifically by the Minister's statement that —

the conclusion I have come to is that we would be better advised not to rely on exchange restrictions, but rather on the general handling of our domestic economic situation to keep us in reasonable balance with the outside world and to maintain the Canadian dollar over the years at an appropriate relationship with foreign currencies. This view has been shared by my colleagues.

Canada is more fortunate than most countries in the wealth of her natural resources and in the degree of industrialization she enjoys. But, as the New York Journal of Commerce recently pointed out, "these advantages, we have learned, do not alone assure a nation the relative balance of international payments which is the long-term prerequisite to free foreign exchanges. It is equally essential that domestic policies be such as to avoid undue stimulation of imports, discouragement of exports, or a flight of capital."

The outstanding record of Canada in balancing the national budget and reducing the national debt each year since the war has been, along with tighter credit policies recently, a good augury of success in her bold undertaking. For the current fiscal year indications are that the original budget forecast for a surplus of $30 million will be substantially exceeded. At the same time the lifting of foreign exchange restrictions should encourage foreign investors, and inure to the benefit of the exchange position and the long-range development of the country.

Moves by Britain

The British moves are, as has been said, of a much more limited nature. They involve neither a change in the official parity of $2.80 to the pound, or any basic alteration of the exchange control as it affects Britain's international trade. In the past authorized banks bought and sold foreign exchange, both spot and forward, at fixed rates as agents for the Bank of England and were allowed a commission for so doing. Now authorized banks are allowed to deal in foreign exchange, both spot and forward, for their own account.

In the case of spot exchange the new regulations provide for a widening of the permitted buying and selling rates from the former $2.80⅛ for buying and $2.79⅞ for selling to $2.82-$2.78. The rate of exchange will be permitted to fluctuate freely between these levels, the Bank of England standing ready to buy at $2.82 and to sell at $2.78, thus effectively holding the spot rate within these upper and lower limits. In a sense these upper and lower limits are similar to the gold receiving and shipping points which prevailed in the days of the gold standard.

In the case of futures, the Bank of England's withdrawal is complete, leaving authorized banks to undertake these operations for their own account and risk, with certain limitations as to the total amount involved which will be agreed upon between the respective banks and the Control. The fact that the banks will now be allowed to undertake more normal exchange operations, involving the (simultaneous) purchase or sale of spot against purchase or sale of futures, is expected to create a broader and more orderly market for forward exchange in the financing of Britain's trade. It would make easier the reopening of the Liverpool cotton market and other private commodity exchanges dependent upon trading in futures. The freeing of the forward rate also makes possible the switching of short-term money between the New York and the London markets.

A feature of the new rules is that sterling may now be freely transferred from Canadian to American account, and vice versa, which heretofore has not been permissible. One of the great headaches of Canada since the war has been that she earns so much in sterling and spends so much in U. S. dollars, yet, owing to the inconvertibility of sterling, has been unable to use these sterling earnings to pay for goods purchased in the United States. The new regulations permitting free interchange of sterling between the Canadian and U. S. markets thus ease the Canadian exchange problem and fortify the newly-established freedom of the Canadian dollar in world markets.

Desire for Freer Markets

That the former system of exchange rates, with fixed differentials between spot and forward rates, was incompatible with the new policy of flexible interest rates in London has been apparent. The significant thing is that, in attempting to meet this difficulty, the British have not moved in the direction of new and more complicated controls, but rather the reverse. Their action is evidence of the new Conservative Government's desire to widen the area of private trading and free markets as rapidly as circumstances permit.

Western Europe's Coal Bottleneck

Western Europe is again facing in acute form the problem of coal shortage. The European countries depend chiefly upon coal for industrial energy and home heating, and insufficient coal production had been one of the principal obstacles to economic recovery until Marshall aid provided funds for coal imports and for rehabilitation of domestic mines. During 1949 and 1950 it seemed that output had finally caught up with demand. But with industrial production pushed to a higher level in 1951, the coal shortage is back again, threatening not only to strangle Western Europe's rearmament program, but also to consume the bulk of the dollar aid set aside for essential imports.

"There is no more significant measure of the inability of the European national states with their national industrial governmental and trade union structures to cope with the present-day economic problems," the New York Times correspondent, Michael L. Hoffman, wrote a few months ago from Geneva, "than the fact that Europe cannot get this coal out of the ground and into the furnaces of industry in sufficient quantities to support the level of economic activity of which the area is otherwise capable." Paul R. Porter, the Economic Cooperation Administration's special representative in Europe, made a similar charge when departing for Paris last month:

> It is a shocking thing that six and one-half years after the end of the war, Europe must still ask us for dollars to pay for the coal that Europeans ought to produce for themselves . . . Coal . . . is the one black mark on Europe's otherwise fine production record . . . I fail to understand how "full employment" [in Great Britain] could be advanced as a reason for not digging enough coal when unemployed Italian workers clamor for a chance to work in the coal mines.

Western Europe's coal imports from the United States during 1951 are expected to total about 25 million tons. During the first quarter of 1952 the coal gap is estimated by the United Nations' Economic Commission for Europe at about 10 million tons. On this basis requirements for all of 1952 may range from 30 to 40 million tons which, at present prices of $22-25 per ton including transportation, could involve an outlay of $700 - 900 million. Hence the cost of coal — something that Europe could produce herself — could nearly exhaust the entire $1 billion originally set aside for economic aid for Western Europe during the current fiscal year, leaving little for other essentials. Washington authorities are reported now to have decided to switch more of the defense funds to economic aid.

Britain may have a coal deficit in excess of 4 million tons in 1952. Strict rationing has already been instituted. The far-flung ramifications of the deficit are illustrated by the following passage from the British Treasury's "Bulletin for Industry":

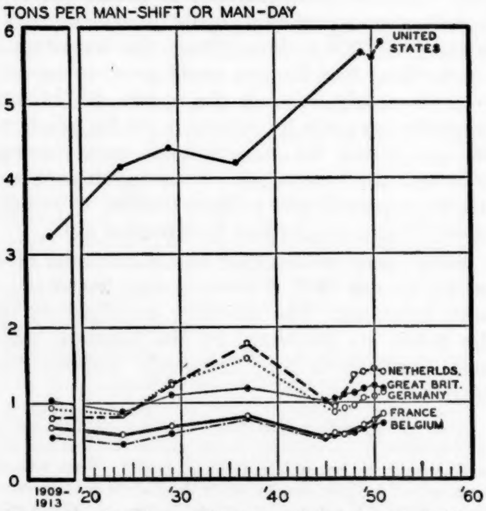
> If we had 20 million tons more coal we could earn some £70 million, if we exported it all (and even then our exports would be below the 1938 tonnage). That would be a useful contribution to offset the deficit we are running with the European Payments Union . . . We could avoid having to import American coal. This has already cost us some $24 million this year — over £7 a ton including freight. This winter each ton may well cost more.
>
> Coal could be exchanged for Swedish ore or for any European raw material we wanted. Next year it will, in all probability, be the lack of rich iron ore which will, more than anything else, hold back steel output.
>
> We could avoid the interference with shipping which coal imports cause. Shortages of shipping space was one of the principal reasons why we did not get enough iron ore this year. We could be sure of adequate supplies of coking coal for the new coke ovens due to come into operation next year.

"There is an excess of demand for coal almost everywhere in Europe, and rationing and allocation schemes have been newly introduced in many countries," reports the Economic Commission for Europe. To get coal, individual European countries are once more resorting to barter.

British inability to deliver coal has contributed to the strains on the European Payments Union. In France, which is the largest coal importer in the world, coal — and more particularly coke — shortage is holding steel production some 10 - 15 per cent below capacity.

Prewar Production and Pattern

Western European coal shortage and dependence upon American coal is a post-World War II development. Certainly there was no hint of coal shortage prior to World War I. In those days the free flow of trade, capital, and labor favored competition among the various European coalfields. Productivity of the coal mines, except for the French and Belgian, was roughly one ton per man-shift. Contemporary productivity in American bituminous mines, however, was already more than three times that as will be seen from the chart below:



Productivity in Western European and American Coal Mines

The splitting of Upper Silesia between Germany and Poland, the Ruhr disturbances during the occupation period, the several years of labor disputes in Great Britain, and, of course, the mismanagement of mines during the First World War, all set back Europe's coal industry. but there was yet no real shortage. In the late 1920's there followed, as described recently by the London Statist —

> a period of unprecedented technological advance in many Continental coalfields, and of comparative stagnation in Britain . . . In the Ruhr and elsewhere on the Continent, the refitting of the coal mines with modern hewing and conveying machinery was part of the movement of "rationalisation" . . . It is now known that this policy over-taxed the financial capacity of the investing countries, notably of Germany . . . However, "rationalisation" fulfilled its immediate purpose and made it possible to produce larger quantities of coal with the employment of fewer miners . . .
>
> Britain did not participate in the "rationalisation" drive and erred on the side of under-investment, both in mining and in the manufacturing industries . . . Sections of the industry were starved of capital, and many colliery companies lived from day to day, finding it impossible to plan ahead.

There were certain factors that made the modernization of British coalfields an uphill struggle. The best coal reserves had long since been exploited and, in general, the less accessible and thinner seams were the only ones left. The existence of mass unemployment was another factor. Experienced miners drifted away and discouraged their children from going into the pits. All this contributed to the present difficulties.

Coal Production in Western Europe and the United States

	United States(1)	Great Britain	Western Germany	France excl. Saar	Belgium	Netherlands
	Production (millions of metric tons)					
1913	478	292	141	57 (2)	23	2
1924	484	271	118	58 (2)	23	6
1937	446	244	138	58 (2)	30	14
1945	577	186	36	51 (2)	16	5
1947	631	201	71	56 (2)	24	10
1951 (est.)	535	223	119	69 (2)	29	12
	Number of Workers (thousands)					
1909–13	572 (3)	1048	349	195	144	...
1924	620	1214	339	291	172	...
1937	492	778	310	224	143	31
1945	383	709	207	251	158	34
1947	419	711	287	320	160	39
1951 (Aug.)	354	699	403	243	154	43
	Output per man-shift (metric tons)					
1909–13	3.23	1.03	0.94	0.68	0.54	0.82
1924	4.14	0.89	0.86	0.58	0.45	0.84
1937	4.19 (4)	1.19	1.59	0.83	0.78	1.78
1945	...	1.01	...	0.56	0.52	...
1947	5.68 (5)	1.09	0.93	0.59	0.58	0.94 (6)
1951 (Aug.)	5.80 (est.)	1.18	1.12	0.87	0.73	1.40 (7)

(1) Coal and lignite. (2) France incl. Saar. (3) 1913. (4) 1936. (5) 1949. (6) 1946. (7) July.

By 1937, British coal mines with almost 500,000 fewer miners than before the depression still produced enough coal to permit exports of some 50 million tons. Western Germany and Poland had a combined export surplus of 65 million tons. Other European countries meanwhile made themselves less dependent upon coal imports through the development of their own coal fields (Netherlands and Italy) or their water-power resources (Italy, France, Switzerland, Austria). Modernization raised output in Germany and the Netherlands to almost 1¾ tons per shift. In the United States, however, output per man-day was above 4 tons.

Effects of World War II

The disorganization and damage suffered by the European coal industry from World War II far exceeded the setback after World War I. The Upper Silesian coal mines, which were among the best on the Continent and produced about 100 million tons, were left behind the Iron Curtain. The flow of East European labor to French and Belgian mines stopped. It took

time to reassemble the dispersed old workers and to train new ones.

The mines in Germany and the Netherlands, which achieved the highest productivity before the war, were among those most severely damaged. Although German coal mines employ about 100,000 more workers than before the war, considerably less coal is produced.

In Great Britain, the mines were nationalized in 1947, and the National Coal Board proceeded with a plan of long-range modernization, including new sinkings and drastic reconstruction of existing pits. But as one competent observer put it, "It has been a race between the inflow of new methods and the outflow of workers." With some 80,000 fewer workers than before the war, the coal mines now produce 20 million tons of coal less. If this amount could be made up and exported it would go a long way toward solving Britain's balance of payments problem and ease the European dollar shortage.

Relatively, the greatest postwar improvement was achieved by coal mines in France and the Saar, which profited from large investments under the Monnet Plan. The Belgian mines remain among the highest-cost producers in Western Europe. There has been little modernization for years, and wages scales are relatively high.

Prospects for Closing the Coal Gap

Since Western Europe has enough coal reserves, as well as manpower, skill, and machinery, the problem of getting coal out of the ground and of releasing dollars for other essentials should not be unsurmountable. According to a recent dispatch to the New York Journal of Commerce from Paris, the Organization for European Economic Cooperation, a Marshall Plan body, is working on a long-range plan calling for an investment of some $2 billion in enlarging and modernizing the coal mines between now and 1956. The forthcoming report of the O.E.E.C. is expected to argue for the spending of this amount as economically sound by pointing out that coal imports from the U.S. will cost Western Europe $3 - 4 billion during the next four years. Other long-range plans call for further development of waterpower resources. More efficient use of coal is also being studied, particularly in Great Britain.

Another view is that the coal crisis could be relieved much earlier by concentrating on expanding output in the two key surplus countries, Great Britain and Western Germany. As some observers point out, this could be accomplished by more efficient management, by inducing the miners to work harder and longer hours, and above all, by attracting more miners into the pits by paying them higher wages and by relocating labor surpluses from other countries.

The proposed decentralization of the coal industry — now run in Great Britain as a single government enterprise — is expected to produce more flexibility and efficiency, as happened in France. British coal mining operations have been on a five-day-week basis, with six-day overtime voluntary. To quote again from the above Paris report to the Journal of Commerce:

> Since overtime pay is taxed as much as regular wages, the U.K. is having trouble inducing miners to put in the extra time. It is being suggested, therefore, that this sixth-day work be placed on a tax-free basis. Six-day per week operations alone would yield some 10 million tons more coal annually and would run fewer political risks than the much-discussed plan to import Italian coal miners.

A plan for the importation of 5,000 Italian workers was agreed to by the British mine unions after the last wage award. However, local lodges have opposed the scheme and only a fraction of some 1,100 Italian miners imported thus far are employed in the pits.

In contrast with Great Britain, there is no manpower problem in Germany, where the expansion of Ruhr coal production is particularly desirable because of its unique coking properties. In Germany, the main problem is investment capital for the improvement of badly overcrowded housing and for the replacement of worn-out mine equipment. But capital investment hinges partly on the future ownership of the mines, still under the shadow of nationalization, and upon the implementation of the Schuman Plan. Without this Plan, recently ratified by the French National Assembly, there will always be fear that Western Germany may attempt to control the rest of the Continental steel industry by means of the supply and price of Ruhr coal.

Solution of the coal problem will not be easy. It will require overcoming strictly nationalistic considerations both to move skilled labor from one country to another and to invest capital where it is most needed. The chronic problem of Western European economic integration and of mutual aid, faced at the time of setting up the Marshall Aid Plan, is illustrated vividly in this industry.